Statement of

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on

Proposals for Terror Reinsurance
before the

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Mr. Chairman, and members of the Committee, thank you for the opportunity to present our views on proposals for terror reinsurance. The 335,000-member National Taxpayers Union strongly opposes the proposals offered by the insurance industry and the Administration, both of which would violate key principles of sound insurance policymaking. These flaws would put lives and property in danger and expose taxpayers to unnecessary losses.

Congress should move cautiously as precedents may be created for congressional responses to other large losses and major insurance industry difficulties.

Unless insurance companies have to pay--and pay a lot--for Federal reinsurance, they will compete by giving the coverage away to clients. This creates moral and security hazards. Second--and this is very important--they will have no incentive to underwrite individual risks with any caution, to avoid concentration risks or to help their clients reduce their risks. They will assume more risk for the government than they ever would have if their own money were at risk.

It is essential to limit the government's total liabilities, set firm limits per policy, clearly define terrorism and limit the government’s exposure to certain types of loss (e.g., business interruption). Otherwise, we could be paying companies not to be going back to work for years. Of course, the insurers should have to pay enough of the claims, a minimum of 20 percent in the first year, to carefully monitor claims administration.

Too often legislation is passed as a quick response to a problem without addressing fundamental flaws in public policy. During our work over the last six years studying proposed legislation and public policy regarding natural disasters, we have found that a number of Federal and state laws and regulations greatly hamper the ability of the private sector to provide insurance for catastrophes.

Perhaps the most important impediment to affordable insurance against man-made or natural catastrophes is the Federal tax law, which contains a huge implicit tax penalty on businesses and homeowners who attempt to purchase such insurance. These same laws prevent insurance companies from deducting an amount equal to the risk of catastrophic natural disasters or terror attacks; amounts that we consider legitimate business expenses. We hope this problem will be corrected and urge the Committee to use the Policyholder Disaster Protection Act (HR 785), by Representatives Foley and Matsui, as a starting point.

It is not clear to us whether a Federal terror reinsurance program is needed at this time. Certainly it is completely unacceptable to enact a program that would increase risks to lives, property and federal finances.

Insurers are not claiming they are in trouble, only that the market may fail to respond to higher pricing with more capacity. That's dubious at best and there's a good case to be made that we ought to wait and see what happens in the market. Even if terrorism is excluded from some policies, life and business will certainly go on.

The Fidelity Select Insurance Fund is up about 3 percent since September 10. Insurance stocks' performance shows a great deal about market experts' view of the industry's future claims-paying ability, future risk, and the opportunities associated with expected higher pricing. It also shows--along with the new company announcements--that the capital markets have in no way restricted the industry's ability to raise capital and take on additional risk.

If Congress enacts such a reinsurance program, we strongly urge you to be guided by the following principles.

1. Any Federal capacity should offer the maximum amount of economic benefit to the nation as well as injured parties at the lowest possible cost to the taxpayer.

2. Legislation must not erode strong incentives for wise underwriting and insurance company management of risks (e.g., proper security and escape contingency plans). If no reinsurance is available, then the insurance industry will continue to cover claims until their current policies expire or a time the current policy allows for modification of the coverage. Until then, the insurance companies have an extremely high incentive to help their clients take sensible steps to reduce their risk of terrorism loss. Likewise, if a business finds it cannot insure for terror risks when its policy expires, it too will take much more vigilant steps to secure its property, customers and employees. A blank federal reinsurance check would eliminate a very important incentive to increase security.

3. If Federal reinsurance capacity is offered, then there should be payment for the use of that capital and assumption of risk. Any plan that fails to collect premiums is a giveaway that will increase losses from any future attacks since it would undermine insurer incentives to boost security and create effective disaster control and reaction plans. It would be irresponsible to discourage effective safeguards that can reduce the

number of lives and amount of property that could be lost from a terror attack. While no one knows how to price this risk since the market is not offering it now, the government should use very conservative assumptions in pricing for that risk so that the private sector can retake this market as soon as possible.

4. Federal coverage should certainly not insure against all industry terror losses. Coverage of the first dollar of losses is both unnecessary and unwise because this too will erode incentives to increase security. Lower levels of financial risk should remain in the private sector, which will attempt to price the insurance for the limited risk. Those price signals will provide important pricing information to the government for the use of its capacity. If the government provides coverage, we strongly recommend restricting coverage to property loss and workers' compensation only. If insureds also want business interruption coverage, they can go to the private sector for supplemental coverage.

5. Federal reinsurance capacity should be temporary, maximize the use of market mechanisms and encourage the reentry of private reinsurance at higher levels at the earliest possible date. We must rigorously avoid any establishment of a permanent entity. Insurance is available for many other large and highly uncertain risks and terror insurance will be more efficiently administered and priced by the private sector in the long run. It is too easy to make a mistake in haste, which could prove impossible politically to fix later.

6. Legislation must contain strong incentives to pay only valid claims. The Federal government's co-payment of claims should never exceed 80 percent. It is easy for insurance companies to keep customers happy if they have little or no financial incentive to monitor claims for fraud and overpayments.

7. The federal government's exposure must be capped to preserve America's national security options. The Federal government must not insure against unlimited terror or war risks. In the event of a war or a terror attack with weapons of mass destruction, the losses would be far more serious than experienced in the September 11th attacks. The government needs to limit its liability so that it can preserve the fiscal flexibility needed to fight a war.

8. Incentives should be created to get the federal government out of this business and reduce its role to covering a higher layer of loss as early as possible.

9. A mediation panel is needed to quickly pay and settle claims for terror losses in a fair and inexpensive way. However undesirable it may be to spend taxpayer monies on terrorism losses of property, it will be completely unacceptable to pay large amounts to the trial bar in the aftermath of an event, and further slow the process of getting funds into the hands of rightful recipients. Any non-productive activity such as litigation, which slows the process of pricing the event, will lead to more uncertainty in repricing insurance for future events and will add to the ultimate cost of such events. Such a variation was included in the airline industry bailout. If people do not wish to waive their rights to sue, then they should purchase their own terrorism coverage, unsubsidized by the government.

10. Legislation should contain a clear definition of what is a terror loss, and all other losses should be excluded from coverage. The formulation of coverage will need to be quite specific or there will be lots of opportunities for financial mischief at taxpayers' expense. This definition would then need to be met on any private industry claim payment, prior to allowing either the customer or the insurance company to present the balance of the claim to the government. If this definition is not clear or not rigorously applied, there will be endless disputes.
11. Federal law should override any state terror insurance regulations until the Federal capacity has disappeared.

The Insurance Industry Proposal

We are strongly opposed to the industry bill as presented in its most recent draft, which is riddled with both short and long-term flaws. It is completely contrary to at least principles 1-10 listed above.

The proposal appears to create an unlimited liability for the Federal government for terror risks. The legislation also covers an unclear amount of war risks. As noted above, the Federal government must have complete flexibility during war because the most important function of our government is to defend the country. We cannot and must not create an entitlement program to insure against all terror or war risks, which may cripple the financial capacity of the government to win the war.

This proposal initially offers no payment to the Federal government for its reinsurance capacity, and it is quite possible that no payment would ever be forthcoming. We are strongly opposed to any such giveaway. Just because it is difficult to properly charge for the risk doesn't mean that nothing should be charged.

The pool concept is fundamentally flawed, and there are better alternatives. It allows companies to be looser in their underwriting and increases moral hazard problems compared to alternatives. Companies could shift risk in an undetectable manner to the pool.

Another key concern is that the proposal would set up a permanent bureaucracy that would greatly expand its mission over time, concentrating risk and displacing a healthy reinsurance market.

This facility would have enormous advantages that no other firm could match, including tax-free reserving, explicit access to Federal credit and a location in one of the least-regulated states in the country. At the end of its "life" there is to be a report on the state of capacity in the industry, not just for terror, but for other large risks currently handled by the private sector such as natural disasters.

We understand that the proposal has a sunset clause, but are not reassured. Once federal programs start, they rarely disappear, and this entity will have powerful allies who will likely seek to dump their other least attractive risks on the taxpayer. Important sectors of the industry have been trying for years to push legislation through the Congress to set up a natural disaster insurance corporation, and this entity could well take on that role as it is about to supposedly expire.

The inherent advantages of the proposed "Homeland" insurance entity would make it almost impossible for the private sector to move back into the business of insuring against terror risks as it could not compete against Homeland's awesome advantages in amassing tax-free reserves and accessing Federal credit.

Attached to my statement are additional section-by-section comments on the proposed legislation.

The Administration Proposal

The proposal is a public-private sector program. In 2002, the government would absorb 80 percent of the first $20 billion of insured losses resulting from terrorism, and 90 percent of insured losses above $20 billion.

In 2003, the private sector would handle the first $10 billion of loss. Losses between $10 billion and $20 billion would be shared, with the government paying 50 percent and the private sector paying 50 percent. After losses exceed $20 billion, the government would cover 90 percent of losses, and the private sector would cover 10 percent.

In 2004, the private sector would cover the first $20 billion in losses. Between $20 billion and $40 billion of losses, the government and private sector would each cover 50 percent of the losses. At above $40 billion in losses, the government would pay 90 percent of losses.

Overall liability would be capped at $100 billion.

The Administration plan has fewer flaws than the industry plan, but these flaws are also huge. It violates at least principles 1, 3, 6, 9 and 10 above and principles 2 and 4 in its first year of operation.

It too fails to collect any premium for the risk taken by the Federal government. A failure to collect premiums is a giveaway that might increase terrorism losses since it would undermine incentives to boost security and create effective disaster response preparations. It must collect a premium for the exposure.

In its first year of operation the Administration proposal covers the first dollar of losses, which is unnecessary and unwise. To minimize the danger to lives and property, insurance companies must have a financial stake in mitigating claims, which they will help enforce on their clients.

Coverage of the first dollar of losses for all insurance companies would also lead to an unnecessary increase in Federal bureaucracy, costs, and insurance waste. It is hard to find any consumer or business insurance policies that do not have some form of a deductible, and Federal terror reinsurance shouldn't eliminate this sound principle of insurance.

If the Federal government must participate in every loss, no matter how small, clearly there will be far less incentive for claims to be processed by the insurance companies in a way that is fair to the taxpayer. Any such proposal should leave some level of losses to be paid first by the insurance companies. After that level, the co-payment by the insurance companies must be substantial in order to guard against excessive payments.

Claims handling will be a key element of the coverage. Someone will need to provide people to perform this function or at least audit it, and it wouldn't seem that the small percentages of loss coming from the industry would be effective in getting them to police themselves and their customers effectively.

As you can imagine, these companies are currently buried under an avalanche of claims arising from September 11, many of which either are fraudulent or contain elements of fraud. They will police these as best they can, but we would want, if anything, even more diligence in the future when less of their own money is involved, as would be the case with the Administration proposal.

From an insurer's standpoint, it is a lot easier to make your long-term customers happier when you are paying out dollars to them that cost you as little as 10 cents, the standard under the Administration proposal.

We should note that the "industry" doesn't insure anything; individual companies do, and these companies vary considerably in their capabilities and capacity. It isn't apparent how the Administration's plan would distribute the losses around the industry. Individual companies write individual risks that will incur discreet losses (some of which might be covered, some not under normal policy conditions), then claim payments are made as negotiated with each individual client. Risks and losses are not distributed proportionately around the market, as will be seen when the cost of September 11 is tallied.

This week *The New York Times* reported that Berkshire Hathaway chief executive Warren Buffett said, "I think there is nothing wrong with having the industry lose a lot of money if something like [a terror attack] happens. We just have to keep it within the ability of the industry to pay. The industry can pay for a $10 billion loss. It can't price for a $500 billion loss."

Lower levels of exposure should remain in the private sector, which will price the insurance for the limited exposures. Those price signals will provide important pricing information to the government for its reinsurance capacity.

Compared to the industry proposal, the Administration approach creates less bureaucracy and clearly has a much better chance of being temporary, which is a plus.

The Administration proposal does cap the exposure, though the exposure level is very high.

Improving the Administration Proposal

The Administration proposal can be greatly improved with a few key modifications. Clearly, the Federal government must charge for its reinsurance capacity and the coverage should kick in at higher levels.

While it may seem like a good idea for the Federal government to stay out of pricing, we must not lose sight of the fact that the Federal government is offering $88 billion in reserves against terror losses. It should certainly charge some reasonable amount for that risk.

If the insurance companies are covering only 12 percent of losses, then they should be receiving, on average, 12 percent of the associated premium. Since there is no traditional way to estimate or annualize losses, there probably should be a nominal "load" established to be added to every dollar of non-terrorism premium.

Perhaps the Treasury could simply assume that such losses could occur every ten or twenty years, and price the reinsurance or capacity according to that time horizon.

We strongly recommend that the first year of the program also require that the private sector cover at least the first $10 billion of losses. Between $10 billion and $20 billion the government would cover 50 percent of additional losses. Between $20 billion and $100 billion, the government would cover 80 percent of additional losses.

In 2003, the private sector should cover the first $15 billion of losses. Between $15 billion and $25 billion, the private sector should cover 50 percent of losses, and between $25 billion and $100 billion, the government would cover 70 percent of additional losses.

In 2004, the private sector should cover the first $25 billion of losses. Between $25 billion and $100 billion, the private sector should cover 50 percent of losses.

Conclusion

Proposals for Federal insurance for terror and war risks are both politically and economically risky and should be subjected to extensive examination and comment before being enacted into law. We strongly urge the Committee to remember that even the best-intentioned programs can have budget-busting consequences. In this case, a poorly designed program would also place more lives at risk and conceivably harm the financial ability of the government to defend the country. Congress must move carefully in this highly complex area to ensure that it does not create a fiscal disaster, unwisely interfere with private markets or violate sound insurance principles.

Attachment

Section by section discussion of the Insurance Stabilization and Availability Act of 2001

Sec 2. The findings could recognize that there are sufficient uncertainties surrounding the commercial market at the present time to consider establishing a facility. If it is advisable to create a facility at the Federal level, the purposes should clearly state that the facility should interfere with the market function as little as possible and should, to the maximum extent possible facilitate the re-entry into the market of commercial entities.

Sec 101. Why not a federally regulated and chartered entity? Why subject to state laws at all? If the Federal government funds it, then the Federal government must regulate it.

It is unclear how much financial exposure would be created by the war risks covered by the proposal. Parts of the bill seem to limit such exposure to workers' compensation, while other portions seem to permit broader coverage. Even workers' compensation may set up unacceptably large financial risks for the Federal government during a war.

Sec 103 a. This provision should instead say something to the effect that "The Secretary shall establish an entity for the sole purpose of applying Federal resources to the issue of risk transfer from private enterprise and individuals, through the mechanism of the private insurance industry."

Sec 103 b 1. Why "irrespective of Homeland's available funds" during the first year? Why isn't Homeland always required, first and foremost to pay out, down to some reasonable base amount, before other resources are tapped?

Sec 103 b 3. Should instead state that "The Secretary shall determine the charges to be paid by Homeland, and Homeland shall determine the charges to be made for such coverages." The requirement that Federal reinsurance be made available at no charge is both unwise and unacceptable.

If this approach is taken, there is merit in the view that Homeland should always be the sole provider of terrorism coverages in the United States. This is essential or Homeland and the Treasury will be the target of adverse selection and predatory pricing which will attempt to "cherry pick" the more desirable risks against Homeland.

Clearly there will be a commercial market available in many areas. The insurance industry just can't figure out how to deal with the bigger, tougher risks, not all risks. As the Administration noted in its briefing last week, "The attacks that took place on September 11th were against the physical structure of the World Trade Center, but they were really against the nation as a whole. So there's some logic and rationale that . . . other symbols . . . do not have to pay exceptionally high rates."

Moreover, it should be a stated objective of Homeland and the Secretary to re-establish a viable commercial market as quickly as possible. A piecemeal approach will not hasten that result because it will pass the most difficult and complex risks out of the commercial market.

Sec 104 b. This provision should provide added flexibility to allow Homeland and the Secretary to purchase retrocessional capacity elsewhere as they see fit. In particular, it may be possible to securitize this risk through the equivalent of CAT bonds or some other instrument such as excess-of-loss contracts as suggested by Christopher M. Lewis in his studies on providing additional insurance capacity for natural disasters.

Sec 105. We don't agree that Homeland should be organized in this way. Perhaps this section should require that "All companies licensed to conduct business (or conducting business) in the US shall be required to cede these defined risks to Homeland." There is no need to make the companies members. This shouldn't be a "club," and the members shouldn't own it unless they fund it.

Sec 106. As noted above, it is completely unacceptable that a State would have control over an entity whose risks are almost completely underwritten by the Federal government.

Again, if this approach is taken, Homeland needs an oversight board and a clear charter to minimize Federal involvement and increase private sector capacity. To achieve anything logical, Homeland may need some sort of participation, however finite, by the commercial industry to succeed. Full faith and credit doesn't necessarily equate to no commercial involvement. It may be that the terrorism problem is so protracted and so massive that it might become nearly impossible to substitute commercial money for tax money at some level, but the problem may also turn out be much more manageable and localized than is now perceived. Homeland's management should be rewarded for finding ways to slice, dice and parcel out the problem with minimum public money at risk.

Sec 107. These provisions will need much more definition by Homeland to adequately price and underwrite coverages correctly.

Sec 107 b. These definitions are very loose and unclear and could be read to cover many other acts, including gang vandalism or abortion clinic bombings. Do these need to be "known" or could they be "unknown" parties? How tight does the proof need to be to get a settlement in 45 days? What if evidence emerges later that the attack was supported by another nation?

Sec 107 b 2. If coverage is retroactive, then the premium should be retroactive too.

Sec 108 c. It is unclear as to why there is a need for separate divisions.

Sec 109 d. See comments on Sec. 101. No one state should have the right to regulate this entity. Insurance regulation is not the appropriate model in any case. Our current insurance regulatory scheme is notoriously balkanized and antiquated. While it may not be possible to repair this system at this point, it would not be desirable or wise to subject this entity to these weaknesses.

Sec 110. It would be unwise to allow only Homeland to reserve funds for terror risks without payment of taxes, when other domestic insurers and reinsurers are burdened with rules that improperly tax such prudent actions as setting aside reserves for future losses whose timing and magnitude are impossible to determine. All insurers should be allowed to set up tax-free reserves.

Sec 113 a. The legislation should also allow for an earlier expiration date, such as "at such time prior to that as the Secretary determines that a valid commercial market exists for the coverages provided by Homeland."